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Supreme Court, U.S.
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# Supreme Court of the United States

SHELDON KRANTZ,

*Petitioner,*

*v.*

PRUDENTIAL INVESTMENTS FUND MANAGEMENT LLC and PRUDENTIAL INVESTMENT MANAGEMENT SERVICES LLC,

*Respondents.*

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

## PETITION FOR A WRIT OF CERTIORARI

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58 pp

## QUESTION PRESENTED

Whether the United States Court of Appeals for the Third Circuit, in direct contravention of this Court's holding in *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506 (2002), erred in adopting a heightened pleading standard which substantially limits access to Section 36(b) of the Investment Company Act of 1940, the only express private right of action provided to mutual fund investors, by requiring that complaints plead evidence not publicly available.

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Petitioner respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

## OPINIONS BELOW

The opinion of the District Court (10a - 22a) is officially reported at 77 F. Supp. 2d 559. The opinion of the United States Court of Appeals for the Third Circuit (1a - 9a) is officially reported at 305 F.3d 140.

## STATEMENT OF JURISDICTION

The judgment of the Court of Appeals was entered on August 30, 2002. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

## STATUTE AND RULE INVOLVED

The text of Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b), and the text of the relevant provisions of Fed. R. Civ. P. 8(a), 28 U.S.C. Rule 8(a), are reproduced beginning at App., *infra*, 23a.

## STATEMENT OF THE CASE

Petitioner, a shareholder of the Prudential Jennison Growth Fund (the "Fund"), commenced this action seeking relief under Section 36(b) of the Investment Company Act of 1940 (the "ICA"), 15 U.S.C. § 80a-35(b). Defendants are the Fund's investment adviser and principal underwriter. The jurisdiction of the District Court was invoked under ICA Sections 36(b)(5) and 44, 15 U.S.C. §§ 80a-35(b)(5) and 80a-43, as well as 28 U.S.C. § 1331 (general Federal question jurisdiction).

As described by this Court,

> Mutual funds pool the investment assets of individual shareholders. Such funds typically are organized and underwritten by the same firm that serves as the company's "investment adviser." The ICA seeks to arrest the potential conflicts of interest inherent in such an arrangement . . . . The [ICA] requires, *inter alia*, that at least 40% of the investment company's directors be financially independent of the investment adviser . . . and that the dealings of the adviser with the [Fund] measure up to a fiduciary standard, the breach of which gives rise to a cause of action by . . . an individual shareholder on the [Fund's] behalf, [15 U.S.C.] § 80a-35(b).

*Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 93 (1991).

The thrust of petitioner's claim is that because the Fund's "independent" directors serve on boards of defendants' multiple investment companies, in exchange for significant compensation, they have neither the time nor the inclination to monitor defendants with the aggressiveness and diligence necessary to fulfill what this Court has described as their legislative mandate to act as "watchdogs" for public investors. *Burks v. Lasker*, 441 U.S. 471, 485 (1979). In other words, they merely rubber stamp defendants' decisions, becoming, in effect, "controlled" by defendants within the meaning of the ICA.

Among the facts and reasonable inferences relevant to the issue of control set forth in the complaint are the following:

- Three of the 11 members of the Fund's board of directors are acknowledged affiliates of defendants.

- The remaining eight directors serve on between 15 and 38 boards of the funds managed by defendants or their affiliates (the "Fund Complex") and receive between $45,000 and $135,000 annually therefrom.

- The "independent" directors' compensation is greater than the collective investment these individuals have in each of the funds within the Fund Complex.

- Defendants' practice of having "independent" directors serve on the boards of between 15 and 38 different funds flies in the face of an explicit warning by industry counsel about "potential conflicts that accompany service on a number of boards." Task Force - A.B.A. Sec. Bus. L., *Fund Director's Guidebook*, 52 The Bus. Law. 229, 240 (1996).

- The number of boards upon which the Fund's "independent" directors serve vastly exceeds the maximum number of directorships recommended by the prestigious, nonpartisan National Association of Corporate Directors.

- The complaint cites a study that examined the relationship between fees and multiple directorships and which "revealed a disturbing pattern: *The more money trustees get, the more shareholders pay in expenses*. This unexpected link between trustees' salaries and fund-family expenses raises serious questions about the role independent trustees play in protecting shareholders." Michael Mulvihill, *A Question of Trust* (Morningstar, Inc. 1996) (emphasis added). In addition, the complaint quotes John Bogle,

founder of Vanguard Group, the second largest mutual fund complex in the United States, to the effect that "independent directors" are sinecures rather than watchdogs.

- From the foregoing facts, which include (i) the number of boards within the Fund Complex upon which each "independent" director serves, (ii) the remuneration received by each "independent" director, (iii) that industry counsel caution against the increased workloads and potential conflicts resulting from multiple directorships, (iv) that the number of directorships held vastly exceeds the outer limits recommended by the prestigious National Association of Corporate Directors, (v) the empirical relationship between highly compensated directors and highly compensated investment advisers, and (vi) the criticism leveled at "independent" directors by industry insider John Bogle, petitioner draws the following reasonable inferences:

> The excessive number of boards upon which the Fund's directors serve and concomitant assembly-line, truncated board meetings, effectively prevents them from being able to fulfill their statutory role as watchdogs for the public investors. Rather, the Fund's board is effectively controlled by [defendants] and merely rubber-stamps proposals of defendants. As a result, each of the directors is an "interested person" within the meaning of ICA Sections 2(a)(3),

> 2(a)(19)(A)(i), and 2(a)(19)(B)(i), 15 U.S.C. §§ 80a-2(a)(3), 80a-2(a)(19)(A)(i), and 80a-2(a)(19)(B)(i).

For the Court's convenience, the operative complaint is reproduced at App., *infra*, beginning at 27a.

In granting defendants' Fed. R. Civ. P. 12(b)(6) motion to dismiss for failure to state a claim upon which relief may be granted, the District Court found that the complaint did not meet a "heightened" pleading standard. (15a.) The District Court also denied petitioner leave to amend. (10a.) The Court of Appeals affirmed, relying entirely on a decision of the Court of Appeals for the Fourth Circuit. Petitioner does not seek review of the Court of Appeals' affirmance of the District Court's denial of leave to amend.

## REASONS FOR GRANTING THE WRIT

### I. The Court Of Appeals' Affirmance Directly Contravenes This Court's Holding In *Swierkiewicz v. Sorema N.A.*

The crux of the District Court's decision is the following:

> Plaintiff's burden to plead facts that state a claim, rather than mere legal conclusions, is heightened here by the statutory presumption against his claim. As set forth in defendants' moving brief, the ICA expressly provides that "[a] natural person shall be presumed *not* to be a controlled person within the meaning of [the Act]." 15 U.S.C. § 80a-

> 2(a)(9) (emphasis added). "The burden of overturning the presumption against control of a natural person is not one that will be lightly assumed or easily carried to success." *Acampora v. Birkland*, 220 F. Supp. 527, 543 (D. Colo. 1963) (*quoting In the Matter of Fundamental Investors, Inc.*, Investment Co. Act. Rel. #3596).

(15a - 16a.) The District Court failed to address either of the following arguments advanced by petitioner: (1) the 15 U.S.C. § 80a-2(a)(9) presumption is an evidentiary presumption, not a pleading burden, as the very next sentence of the statute begins with the phrase, "[a]ny such presumption may be rebutted by evidence"; and (2) *Acampora v. Birkland*, 220 F. Supp. 527 (D. Colo. 1963), is a post-trial decision, irrelevant to pleading issues. -

On appeal, petitioner urged the Court of Appeals that this Court's decision in *Swierkiewicz v. Sorema N.A.* is controlling. The Court of Appeals did not follow *Swierkiewicz*. The Court of Appeals did not distinguish *Swierkiewicz*. The Court of Appeals did not even mention *Swierkiewicz*. Instead, the Court of Appeals elected to follow the Fourth Circuit's "*ratio decidendi*" (6a) in *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321 (4th Cir. 2001), without noting this Court's intervening decision in *Swierkiewicz*.

In *Migdal*, the Fourth Circuit held, in language directly contrary to the holding in *Swierkiewicz*, that ICA Section 2(a)(9) "expressly creates a presumption against control," which "presumption, however, may be rebutted by 'evidence.'" 248 F.3d at 329-30. The Fourth Circuit then went on to examine the complaint for "evidence" of control, concluding as follows:

> There is a presumption under the ICA that natural persons are disinterested . . . which plaintiffs' *evidence* simply fails to counteract. Plaintiffs have thus failed to state a claim that the funds' disinterested directors are in fact interested.

*Id.* at 331 (emphasis added). Corporate boards do not transact their affairs in public. It surely can be no surprise that on a pleading motion, and without being afforded discovery, the plaintiff in *Migdal* was unable to present "evidence" sufficient to overcome the statutory presumption that natural persons are not "controlled."

The litigation posture in *Swierkiewicz* is similar to the instant action. The Second Circuit "require[d] a plaintiff in an employment discrimination complaint to allege facts constituting a prima facie case of discrimination under the framework" established in an earlier decision of this Court. 534 U.S. at 509. The plaintiff did not do so. The district court dismissed the complaint and the Second Circuit affirmed the dismissal. This Court reversed, holding that the Second Circuit's conversion of an evidentiary standard into a pleading requirement was improper. *Id.* at 512.

In language equally applicable here, this Court held that:

> imposing the Court of Appeals' heightened pleading standard in employment discrimination cases conflicts with Federal Rule of Civil Procedure 8(a)(2), which provides that a complaint must include only "a short and plain statement of the claim showing that the pleader is entitled to relief." Such a statement must simply "give the defendant fair notice of

> what the plaintiff's claim is and the grounds upon which it rests." This simplified notice pleading standard relies on liberal discovery rules and summary judgment motions to define disputed facts and issues and to dispose of unmeritorious claims. "The provisions for discovery are so flexible and the provisions for pretrial procedure and summary judgment so effective, that attempted surprise in federal practice is aborted very easily, synthetic issues detected, and the gravamen of the dispute brought frankly into the open for the inspection of the court."
>
> Rule 8(a)'s simplified pleading standard applies to all civil actions, with limited exceptions. Rule 9(b), for example, provides for greater particularity in all averments of fraud or mistake. This Court, however, has declined to extend such exceptions to other contexts.

*Id.* at 512-13 (citations and footnote omitted).

As described, *supra*, the complaint not only provides notice to defendants of petitioner's claim of lack of independence (defendants do not contend otherwise) but includes substantial factual allegations and reasonable inferences supporting such claim. Among such allegations are those dealing with board members' substantial compensation, their purporting to act as "watchdogs" for up to 38 separate registered investment companies, their ignoring cautionary warnings from industry counsel about multiple directorships, and their ignoring the non-partisan National Association of Corporate Directors' recommendations on multiple directorships. There can be little doubt that defendants are on

notice of the alleged breaches of fiduciary duty. If defendants think otherwise, the proper response is for them to "move for a more definite statement under Rule 12(e) . . . ." *Id.* at 514. *See also In re Kauffman Mut. Fund Actions*, 479 F.2d 257, 263 n.4 (1st Cir. 1973) ( "[t]he presumption supplied by [ICA Section 2(a)(9)] . . . whatever may be its effect at a trial, could not be used to contradict the complaint"). There also can be little doubt that the complaint (27a - 39a) contains far more detail than the forms of complaints set forth in the Federal Rules of Civil Procedure Forms. *Swierkiewicz*, 534 U.S. at 513 n.4.

Accordingly, the Court of Appeals' failure to mention, let alone apply, either the holding or reasoning in *Swierkiewicz* warrants a grant of certiorari.

## II. The Court of Appeals' Decision Creates An Unreasonable Barrier To ICA Section 36(b)

At December 31, 2001, "[a]n estimated 93.3 million individuals in 54.8 million U.S. households" owned 76% of the almost $7 trillion of mutual fund assets. Investment Company Institute, *2002 Mutual Fund Fact Book* 37 (42d ed. 2002). If a mutual fund's independent directors fail in their role as "watchdogs," the ICA provides only one express private right of action for these 93.3 million individuals – Section 36(b), 15 U.S.C. § 80a-35(b). Creating artificial barriers to investors' recourse to Section 36(b) results in "denial of a private right of action to those for whose ultimate protection the legislation is intended [and] leaves legislation highly publicized as in the public interest in fact sadly wanting, and even delusive, to that end." *Goldstein v. Groesbeck*, 142 F.2d 422, 427 (2d Cir. 1944).

Neither the Third Circuit here, nor the Fourth Circuit in *Migdal*, provide any guidance as to what must be pled in order

to satisfy the heightened pleading standard for "control." The District Court relied on *Verkouteren v. Blackrock Fin. Mgmt., Inc.*, 37 F. Supp. 2d 256 (S.D.N.Y. 1999). *Verkouteren* demonstrates why a heightened pleading standard on the issue of "control" is the equivalent of a death knell. In *Verkouteren*, the court reviewed the complaint for indicia of control, including "social relations," "the amount of time spent by directors at meetings," "participation in recommending, evaluating, and terminating policies," "independent knowledge of corporate affairs," and "actual domination and operation" (37 F. Supp. 2d at 261), all matters about which a plaintiff can be expected to have little, if any knowledge, in the absence of discovery. Thus, the practical result of a heightened pleading standard is to preclude an investment company shareholder from looking behind the facade of a self-proclaimed independent director.

In 1940, when the ICA was enacted, there was a total of 68 mutual funds. Investment Company Institute, *2002 Mutual Fund Fact Book* 61 (42d ed. 2002). In 1970, when Section 36(b) was added to the ICA, there was a total of 361 mutual funds. *Id.* Today, largely as a result of marketing strategies employed by the asset management industry, there are well over 8,000 mutual funds. *Id.* In recent years, the industry has witnessed the development of huge mutual fund complexes. The 25 largest mutual fund complexes managed 74% of the almost $7 trillion of mutual fund assets at December 31, 2001. *Id.* at 35.

The asset management industry finds it administratively convenient to appoint the same individuals to the boards of all or a large segment of a mutual fund complex, resulting in management and oversight on a fund complex-by-fund complex basis. However, the ICA requires management and oversight on a fund-by-fund basis. *See, e.g.*, ICA Sections 10(a), 15 U.S.C. § 80a-10(a) ("No registered investment

company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company."); 15(c), 15 U.S.C. § 80a-15(c) ("[I]t shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company . . . ."); and 36(b), 15 U.S.C. § 80a-35(b) ("[T]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation . . . .").

Decisions such as those by the Third Circuit here and the Fourth Circuit in *Migdal*, recognize the existence of huge mutual fund complexes and the practice of appointing the same individuals to the boards of all or many of the funds within a fund complex. Such decisions, however, ignore the ICA's statutory scheme and dilute the protections afforded investors therein. It is not the role of the judiciary to modify laws by sacrificing investor protection in order to sanction current industry practices, but to apply unambiguous laws as written. *Barnhart v. Sigmon Coal Co.*, 534 U.S. 438, 460-61 (2002); *Harris Trust & Sav. Bank v. Salomon Smith Barney, Inc.*, 530 U.S. 238, 254 (2000).

A different panel of the Third Circuit, quoting Section 36(b)'s legislative history, noted that the purpose of ICA Section 36(b) is to provide a realistic "mechanism by which the fairness of management contracts could be tested in court." *Green v. Fund Asset Mgmt., L.P.*, 245 F.3d 214, 225 (3d Cir. 2001), *aff'd*, 286 F.3d 682 (3d Cir.), *cert. denied*, 123 S. Ct. 116 (2002). The decision of the Court of Appeals in this action sanctions an unrealistically high pleading threshold which effectively prevents investors from testing "the fairness of management contracts."

## CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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**OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT DATED AND FILED AUGUST 30, 2002**

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 02-1266

SHELDON KRANTZ, *Appellant*
v.
PRUDENTIAL INVESTMENTS FUND MANAGEMENT LLC; PRUDENTIAL INVESTMENT MANAGEMENT SERVICES LLC

On Appeal From the United States
District Court For the District
of New Jersey
(D.C. No. 98-cv-03722)
District Judge: Honorable Katharine
S. Hayden

Before: BECKER, *Chief Judge*, ROTH and
RENDELL, *Circuit Judges*.

(Filed: August 30, 2002)

OPINION OF THE COURT

PER CURIAM.

Plaintiff, a shareholder in the Prudential Jennison Growth Fund (the "Fund"), brought this action pursuant to § 36(b) of the Investment Company Act of 1940, as amended (the "ICA"), 15 U.S.C. § 80a-35(b), against Prudential Investment Fund Management LLC, the investment adviser to the Fund (the

"adviser"), and Prudential Investment Management Services LLC (collectively, "Prudential").[1] Plaintiff alleged that the investment advisers received excessive compensation in breach of their "fiduciary duty with respect to compensation" set forth in § 36(b) of the ICA, 15 U.S.C. § 80a-36(b). The District Court entered an order dismissing the action for failure to state a claim. Fed. R. Civ. P. 12(b)(6). Because we agree that Plaintiff has failed to state a claim that the compensation received by the investment advisers was received in breach of their fiduciary duty, we affirm the order of the District Court.

## I. Allegations and Standard of Review

Section 36(b) of the ICA provides that an investment adviser has a "fiduciary duty with respect to the receipt of compensation." 15 U.S.C. § 80a-35(b). Section 36(b) also provides for a private cause of action by a shareholder against the investment adviser and principal underwriter "for breach of fiduciary duty in respect of ... compensation" paid by a fund. *Id.* Section 10(a) of the ICA, 15 U.S.C. § 80a-10(a), mandates that at least 40% of the members of the governing board of every registered investment company not be "interested persons," i.e., they must be independent of the investment

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[1] The original Complaint was filed on August 7, 1998. Defendants moved to dismiss the Complaint arguing, *inter alia*, that Plaintiff lacked standing to assert derivative-type claims on behalf of any Prudential Funds other than the one for which he was a shareholder. In response, Plaintiff filed an Amended Complaint on December 10, 1998, which was substantially similar to the original Complaint except that it asserted claims only on behalf of the Fund, and not on behalf of all similarly situated Prudential funds.

adviser. Such directors are generally referred to as independent directors. Section 15(c) of the ICA, 15 U.S.C. § 80a-15(c), mandates that every agreement with an investment adviser or distributor be approved by a majority of independent directors. The Amended Complaint seeks to recover the fees paid by the Fund to its investment adviser and distributor, pursuant to management and distribution agreements which were allegedly entered into in violation of §§ 10(a) and 15(c) of the ICA. 18 U.S.C. §§ 80a-10(a), 80a-15(c). The Amended Complaint also contends that the fees authorized were excessive.

Plaintiff's Amended Complaint alleges that none of the members of the Fund's board are independent, as required by § 10(a), because they serve on numerous other boards for various Prudential funds and receive a large aggregate compensation for their combined services. Plaintiff contends that under such a scenario the independent directors are actually "controlled" by Prudential. Thus, Plaintiff submits that the management and distribution agreements, which establish the fees paid by the Fund to the investment adviser and distributor, were not properly approved as required under § 15(c). Accordingly, Plaintiff argues that the receipt of funds from invalid agreements is a breach of the Defendants' fiduciary duty to negotiate at arm's length under § 36(b). Finally, Plaintiff contends that in addition to violating the independence requirement of § 36(b), the Defendants also violated § 36(b) because their adviser-manager's fees agreement were so disproportionately large that fees amounted to a breach of their fiduciary duty.

Defendants urge that the only facts pleaded were that directors served on multiple boards and were well-compensated. They contend that this was inadequate support either for the claim that the fees were excessive or for the claim that these directors were "controlled" by the financial

adviser. The District Court adopted the Defendants' view, and dismissed the amended complaint.

Our review of a dismissal pursuant to Fed. R. Civ. P. 12(b)(6) is plenary. *Langford v. City of Atlantic City,* 235 F.3d 845, 847 (3d Cir. 2000). "We must determine whether, under any reasonable reading of the pleadings, the plaintiffs may be entitled to relief, and we must accept as true the factual allegations in the complaint and all reasonable inferences that can be drawn therefrom." *Nami v. Fauver,* 82 F.3d 63, 65 (3d Cir. 1996). While Fed. R. Civ. P. 8(a)(2) requires only a "short and plain statement of the claim showing that the pleader is entitled to relief," Rule 12(b)(6) is not without meaning. "Although the pleading requirements . . . are very liberal, more detail is often required than the bald statement by plaintiff that he has a valid claim of some type against defendant." 5A Charles A. Wright and Arthur R. Miller, Federal Practice and Procedure § 1357 at 318 (2d ed. 1990).

II. Dismissal For Failure to State a Claim

This case is one of five virtually identical actions filed by Plaintiff's counsel in district courts in four separate circuits. All of the other courts, including the courts of appeals for the Fourth Circuit and the Second Circuit, have rejected Plaintiff's arguments. *See Migdal v. Rowe Price-Fleming Int'l, Inc.,* 248 F.3d 321, 330 (4th Cir. 2001); *Verkouteren v. BlackRock Fin. Mgmt., Inc.,* No. 98 Civ. 4673, 1999 WL 511411, at *4 (S.D.N.Y. July 20, 1999), *aff'd,* 208 F.3d 204 (2d Cir. 2000); *Krantz v. Fidelity Mgmt. and Research Co.,* 98 F. Supp. 2d 150, 157 (D. Mass. 2000); *Strougo v. BEA Assocs.,* No. 98 CIV 3725, 1999 WL 147737, at *3 (S.D.N.Y. Mar. 18, 1999).

The complaint in the Fourth Circuit asserted two related claims:

> First, plaintiffs alleged that the investment advisers breached their fiduciary duty under Section 36(b) because the fees they received were excessive. Second, plaintiffs contended that the "independent" directors of each of the mutual funds were not actually disinterested parties as required by the ICA. *See* 15 U.S.C. §§ 80a-10(a) and 80a-15(c). Specifically, several of the funds' disinterested directors served on the boards of between twenty-two and thirty-eight other funds within the T. Rowe Complex. For their services, these directors received aggregate compensation of either $65,000 or $81,000 for their services on these multiple boards. Plaintiffs alleged that since forty percent of the boards were not disinterested, the advisory agreements could not have been properly approved as required by Section 15(c). Therefore, the defendant investment advisers breached their fiduciary duty under Section 36(b) by failing to negotiate their advisory agreements at arm's length.

248 F.3d at 325. These allegations are functionally identical to the ones made by Plaintiff in this case.

The Fourth Circuit first rejected the claim that the defendants violated § 36(b) because the fees they received were excessive. "In order to determine whether a fee is excessive for purposes of Section 36(b), a court must examine the relationship between the fees charged and the services rendered by the investment adviser." *Id.* at 327. Since the plaintiffs failed to allege any "facts pertinent to this relationship between fees and services," the court concluded that dismissal pursuant to 12(b)(6) was appropriate. We adopt the Fourth Circuit rationale, and, applying it to the Amended Complaint before us, conclude that dismissal for failure to state a claim with respect to excessive compensation was appropriate since Plaintiff failed to allege any facts indicating that the fees received were disproportionate to services rendered.

The Fourth Circuit also rejected the claim that the "independent" directors were "interested" as a result of their participation on multiple boards and receipt of compensation therefrom. Noting that there "is a presumption under the ICA that natural persons are disinterested, *see* 15 U.S.C. § 80a-2(a)(9)," the court concluded that the plaintiff's allegations failed to overcome that presumption. *Id.* at 331. In support of that conclusion, the court pointed out that "neither the ICA nor the SEC proscribes the use of multi-board membership within mutual fund complexes." *Id.* at 330. In fact, as noted, "membership on the boards of several funds within a mutual fund complex is the prevailing practice in the industry . . . Indeed, the SEC has recently reaffirmed its position that 'a director of a fund who is also a director of another fund managed by the same adviser generally would not be viewed as an interested person of the fund under section 2(a)(9) solely as a result of this relationship.'" *Id.* (internal citations omitted). We agree with the Fourth Circuit's *ratio decidendi*. In the Amended Complaint, Plaintiff has failed to allege any facts that, if true, would support a claim that the "independent" directors of the Fund were actually "interested."[2]

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[2] The District Court also concluded that Plaintiff lacked standing because he failed to allege damages, as is necessary under Article III's "case or controversy" requirement. *See Rosetti v. Shalala,* 12 F.3d 1216, 1224 (3d Cir. 1993) ("the plaintiff must show that he personally has suffered some actual or threatened injury"). This conclusion was necessarily subsumed in the District Court's conclusion that the Amended Complaint failed to state a claim. As the court said, "By definition, a violation of Section 36(b) encompasses excessive payments to the fund's advisers. These payments belong to the plaintiff via the Fund. As such, damages would be implicit in a properly pleaded Amend[ed] Complaint. However, Plaintiff

(continued...)

Notwithstanding Plaintiff's characterization that this imposes on him a "heightened standard" of pleading, we agree with the District Court that the statutory scheme here is such that only by alleging facts that, if proved, would render the directors interested will plaintiff be able to overcome the presumption to the contrary. This he did not do. Accordingly, the District Court acted properly in granting the motion to dismiss.

III. Denial of Leave to Amend

Plaintiff also contends that the District Court abused its discretion in denying him leave to amend his Amended Complaint. We review for abuse of discretion. *See Lake v. Arnold*, 232 F.3d 360, 373 (3d Cir. 2000) (standard of review for a District Court's decision to grant or deny a motion to amend the complaint is abuse of discretion). Rule 15(a) of the Federal Rules of Civil Procedure provides that a party may seek leave of the court to amend a pleading and that such leave "shall be freely given when justice so requires." "Among the grounds that could justify a denial of leave to amend are undue delay, bad faith, dilatory motive, prejudice, and futility." *Shane v. Fauver*, 213 F.3d 113, 115 (3d Cir. 2000). A District Court has discretion to deny a plaintiff leave to amend where the plaintiff was put on notice as to the deficiencies in his

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[2] (...continued)
here has failed to properly plead his Amended Complaint, and, as such, the complaint should be dismissed." *Krantz v. Prudential Investments Fund Management, LLC*, 77 F. Supp. 2d 559, 565-66 (D.N.J. 1999). Because the District Court's conclusion on standing was based on the failure to state a proper claim, and was not really an independent ground for dismissal, we do not find it necessary to reach the issue on appeal.

complaint, but chose not to resolve them. *Rolo v. City Investing Co. Liquidating Trust,* 155 F.3d 644, 654 (3d Cir. 1998). In this case, the District Court concluded that "plaintiff should not be granted a second leave to amend when [he] was on notice of the complaint's deficiencies and failed to rectify them with his first amendment." *Krantz v. Prudential Investments Fund Management, LLC,* 77 F. Supp. 2d 559, 560 (D.N.J. 1999). Plaintiff submits that this was an abuse of discretion because he contends that he was not on notice of the deficiencies in his Complaint. We disagree.

Plaintiff claims that he was not "on notice" of the defects in his Complaint because the decision relied upon by the District Court in granting Prudential's 12(b)(6) motion was decided after Plaintiff filed his Amended Complaint. We find this argument unpersuasive. First, Prudential cited *Olesh v. Dreyfus Corp.,* No. CV-94-1664, 1995 WL 500491 (E.D.N.Y. Aug. 8, 1995) in its original motion to dismiss. *Olesh* held that allegations that the directors served on multiple boards and were well-compensated failed to demonstrate that the directors were controlled and failed to state a claim under § 36(b). *Olesh,* 1995 WL 500491 at *11. Thus, Plaintiff was on notice that his allegations that serving on multiple boards and receiving compensation for such service might not be sufficient to state a claim that the directors were interested and could have made changes in his Complaint before filing his Amended Complaint.

Second, we note that *Migdal*, the case on which we primarily rely in reaching our conclusion, and which was also relied on by the District Court, was decided *before* Plaintiff filed his opposition to Prudential's motion to dismiss the Amended Complaint; *Migdal* was decided on January 20, 1999, and Plaintiff filed his opposition papers on February 26, 1999. Thus, we agree with the District Court that Plaintiff was on notice, prior to filing his Amended Complaint and before

responding to the second motion to dismiss, not only of the potential problems with the allegations in his Complaint, but also of the developing case law in this area. As such, the District Court did not abuse its discretion in denying Plaintiff leave to amend his Amended Complaint.

The order of the District Court dismissing Plaintiff's complaint and denying leave to amend will be affirmed.

## OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY DATED JULY 30, 1999

Sheldon KRANTZ, Plaintiff,
v.
PRUDENTIAL INVESTMENTS FUND MANAGEMENT LLC and Prudential Investment Management Services LLC, Defendants.

No. 98-3722 (KSH).

United States District Court,
D. New Jersey.

July 30, 1999.

### ORDER

HAYDEN, District Judge.

This Court having referred defendants' motion to dismiss the plaintiff's complaint to the Honorable Ronald J. Hedges, United States Magistrate Judge, pursuant to 28 U.S.C. § 636(b)(1)(B); the Court having reviewed *de novo* the Report and Recommendation of June 10, 1999; the Court having considered plaintiffs' objections to the Report as well as defendants' response to plaintiff's objections; and the Court concluding that plaintiff should not be granted a second leave to amend the complaint when plaintiff was on notice of the complaint's deficiencies and failed to rectify them with his first amendment;

It is this 30th day of July, 1999

**ORDERED** that the defendants' motion to dismiss the complaint is **granted**; and it is further

**ORDERED** that the Report and Recommendation of the United States Magistrate Judge is adopted and incorporated as the Opinion of this Court.

REPORT AND RECOMMENDATION

HEDGES, United States Magistrate Judge.

## *INTRODUCTION*

This matter comes before me on defendants' motion to dismiss the Amended Complaint pursuant to Rule 12(b)(6) for failure to state a claim upon which relief may be granted. The motion was referred to me by Judge Hayden. I have considered the papers submitted in support of and in opposition to the motion. There was no oral argument. Rule 78.

## *STATEMENT OF FACTS*

Plaintiff, a shareholder of the Prudential Jennison Growth Fund (the "Fund"), brought this action pursuant to Section 36(b) of the Investment Company Act of 1940, as amended (the "ICA"), 15 U.S.C. § 80a-35(b). The Fund is a registered "investment company" within the meaning of the ICA. The defendants are Prudential Investments Fund Management LLC, the investment adviser to the Fund (the "Adviser"), and Prudential Investment Management Services LLC, the Fund's principal underwriter (the "Distributor"). The Distributor is a Delaware limited liability company and an affiliate of the Adviser. The Adviser's principal offices are located in Newark, New Jersey.

The original Complaint was filed on August 7, 1998. Defendants moved to dismiss on October 23, 1998. In response, plaintiff filed an Amended Complaint on December 10, 1998. The Amended Complaint contains a single claim for relief under Section 36(b) of the ICA, 15 U.S.C. § 80a-35(b). ICA Section 36(b) provides that an investment adviser has "a fiduciary duty with respect of the receipt of compensation . . . ." 15 U.S.C. § 80a-35(b). Section 36(b) also provides for a private cause of action by a shareholder against the investment adviser and principal underwriter "for breach of fiduciary duty in respect of . . . compensation" paid by a fund. 15 U.S.C. § 80a-35(b). The Amended Complaint seeks to recover all of the fees paid by the Fund to its investment Adviser and Distributor pursuant to management and distribution agreements (the "Agreements"), which were allegedly entered into in violation of Section 15(c), of the ICA, 15 U.S.C. § 80a-15(c).

Section 10(a) of the ICA, 15 U.S.C. § 80a-10(a), mandates that at least 40% of the members of the governing board of every registered investment company not be "interested persons," *i.e.*, they must be independent to the investment adviser. Such directors are generally referred to as independent directors. Section 15(c), 15 U.S.C. § 80a-15(c), further mandates that every agreement with an investment adviser or distributor be approved by a majority of the independent directors.

The Amended Complaint alleges that *none* of the members of the Fund board are independent, as required by ICA Section 10(a), 15 U.S.C. § 80a-10(a). As a result, plaintiff contends, the Agreements could not be properly approved as required by ICA Section 15(c), 15 U.S.C. § 80a-15(c). Consequently, by reason of their receipt of funds from invalid Agreements, defendants have breached their fiduciary duty to negotiate at arm's-length. 15 U.S.C. § 80a-35(b).

Accordingly, plaintiff seeks judgement: (1) declaring that defendant violated Sections 10(a), 15(c), and 36(b) of the ICA and that the Agreements are void; (2) awarding damages against defendants, including return of all fees paid to it by each of the Funds as well as related relief; and (3) providing any other relief deemed just and proper.

Specifically, the Complaint alleges that the Fund's board of directors consists of 11 members, three of whom are admittedly interested by reason of their employment. The remaining eight directors are not employed by the Adviser, but serve on multiple boards of the funds managed by the Adviser or its affiliates (the "Fund Complex") and receive substantial compensation therefrom (as high as $135,000). Some also accrued substantial deferred compensation (as high as $143,909). As a result, 40% of the Fund's board is not disinterested, as required by ICA Section 10(a), 15 U.S.C. § 80a-10(a), and approval of the Fund's agreements with defendants violated Section 15(c), 15 U.S.C. § 80a-15(c). Such failure to negotiate at arm's-length violates Section 36(b), 15 U.S.C. § 80a-35(b).

Plaintiff also alleges that in addition to violating Section 36(b) by virtue of subverting the independence requirement, the defendants violated Section 36(b) because their adviser-manager's fee were so disproportionately large that it amounted to a breach of fiduciary duty in violation of § 36(b). *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 930 (2d Cir. 1982), *cert. denied*, 461 U.S. 906, 103 S.Ct. 1877, 76 L. Ed. 2d 808 (1983). In this respect, the Amended Complaint describes the widespread criticism of fees paid by mutual funds to their advisers and the advisers' affiliates. These criticisms have been leveled by the Chairman of the SEC, industry analysts, and industry insiders.

Defendants contend that: (1) plaintiff lacks standing since he has failed to allege damages in accordance with Article III of the Constitution, (2) Section 36(b) is limited to actions alleging excessive compensation and the pleadings as now written are insufficiently particular with respect [to] those allegations, and (3) the Fund's directors are disinterested as a matter of law.

Plaintiff argues that: (1) plaintiff has standing since he is a stockholder of the Fund and nothing else is required, (2) Section 36(b) is not limited to actions alleging excessive fees and even if Section 36(b) can be deemed so limited, the Amended Complaint adequately alleges excessive fees, and (3) they so dominated the Fund's board of directors that less than 40% of the board could be deemed "disinterested." Plaintiff also argues that there are additional "facts" that he can add to the Amended Complaint as now written.

**Discussion**

When reviewing a motion to dismiss under Rule 12(b)(6), all material allegations of the complaint are accepted as true [and] the complaint must be construed in favor of the plaintiff. *Warth v. Seldin*, 422 U.S. 490, 501, 95 S. Ct. 2197, 45 L. Ed. 2d 343 (1975). A complaint should be dismissed only if, after accepting as true all of the facts alleged in the complaint, and drawing all reasonable inferences in the plaintiff's favor, no relief could be granted under any set of facts consistent with the allegations of the complaint. *ALA, Inc. v. CCAIR, Inc., 29* F.3d 855, 859 (3d Cir. 1994). A court should allow a plaintiff to amend a complaint instead of dismissing it where "a more carefully drafted complaint might state a claim upon which relief could be granted." *Green v. Fund Asset Management, L.P.*, 19 F. Supp. 2d 227, 230 (D.N.J. 1998) (*quoting Friedlander v. Nims*, 755 F.2d 810,813 (11th Cir. 1985)).

I.

*The Amended Complaint fails to allege that the independent directors are "interested persons" under the ICA.*

Claims brought under the ICA are particularly appropriate for dismissal for failure to state a claim under Rule 12(b)(6). As one court recently observed: "[T]he law in this area imposes a large number of threshold determinations before litigation on the merits of a case may commence. The common law and the ICA explicitly and implicitly regulate who may bring a claim and upon what grounds." *Olesh v. Dreyfus Corp.*, 1995 WL 500491, at *11 (E.D.N.Y. Aug. 8, 1995). The Amended Complaint fails to meet the required "threshold" determinations.

Under the ICA, at least 40% of a mutual fund's board of directors must be independent, *i.e.*, not "interested" in the fund's investment adviser. 15 U.S.C. § 80a-10(a). The ICA defines an "interested person" to mean one of six enumerated categories, 15 U.S.C. § 80a-2(a)(19), including any "affiliated person" of the investment adviser. 15 U.S.C. § 80a-2(a)(19)(b)(I). An "affiliated person", in turn, is defined to include a person or entity "controlled by" another person. 15 U.S.C. § 80a-2(a)(3). The ICA defines "control" as "the power to exercise a controlling influence over the management or policies of a company." 15 U.S.C. § 80a-2(a)(9).

Plaintiff's burden to plead facts that state a claim, rather than mere legal conclusions, is heightened here by the statutory presumption against his claim. As set forth in defendants' moving brief, the ICA expressly provides that "[a] natural person shall be presumed *not* to be a controlled person within the meaning of [the Act]." 15 U.S.C. § 80a-2(a)(9) (emphasis added). "The burden of overturning the presumption against

control of a natural person is not one that will be lightly assumed or easily carried to success." *Acampora v. Birkland*, 220 F. Supp. 527, 543 (D. Colo. 1963) (*quoting In the Matter of Fundamental Investors, Inc.*, Investment Co. Act. Rel. #3596).

Rule 8 of the Federal Rules of Civil Procedure further requires that in a pleading, "facts must be stated, rather than legal conclusions unsupported by facts,...." Charles A. Wright & Arthur R. Miller, *Federal Practice and Procedure;* § 1216 at 152 (2d ed. 1990). A complaint's "bald assertions" or "legal conclusions" do not need to be credited when deciding a motion to dismiss. *Morse v. Lower Merion School District,* 132 F.3d 902, 906 (3d Cir. 1997).

With the presumption that the non-employee directors are not "controlled" and Rule 8's prohibition against pleading legal conclusions, in mind, does the Amended Complaint allege adequate facts? A careful review reveals that it is almost completely devoid of allegations, conclusory or otherwise, that the directors are in fact controlled by any defendant. Plaintiff charges that the independent directors of the Fund are controlled by Prudential--and therefore "interested"--solely because they serve on multiple funds managed by Prudential, for which they receive between $1,000 and $7,500 per fund, for aggregate compensation ranging between $45,000 and $135,000 per year. Paragraph 28 sets forth a table of the compensation received by each of the non-employee directors. The table is supplemented by paragraph 29:

> The excessive number of boards upon which the Fund's directors serve and concomitant assembly-line, truncated board meetings, effectively prevents them from being able to fulfill their statutory role as watchdogs for the public investors. Rather, the Fund's board is effectively controlled by the Adviser and its

> affiliates and merely rubber-stamps proposals of defendants. As a result, each of the directors is an 'interested person' within the meaning of ICA Sections 2(a)(3), 2(a)(19)(A)(I), and 2(a)(19)(B)(I).

These conclusory assertions are not supported by any other allegation. The Amended Complaint does not allege a single instance where defendants' alleged "truncated board meeting" invoked a course of action which prejudiced the shareholders of the funds and should have been resisted by the independent directors. Nor is a single instance alleged in which a proposal was "rubber- stamped" without an informed decision.

The only factual allegation plaintiff does include in the Amended Complaint-- that the Fund's directors serve on boards of multiple funds for which they receive significant compensation--fails to state a claim for relief. Courts have unanimously held so. In *Verkouteren v. Blackrock Fin. Management, Inc.*, 37 F. Supp. 2d 256 (S.D.N.Y. 1999), the court dismissed a complaint filed by the same firm that represents plaintiff here and which was virtually identical to the complaint filed in this action. In *Verkouteren,* the plaintiff alleged that the defendants violated Section 36(b) because the investment advisory contracts were approved by directors who sat on over twenty fund boards for which they received between $140,000 and $160,000 in aggregate compensation. The court concluded that plaintiff's bare allegation that the directors served on multiple boards for substantial compensation was insufficient to plead domination. *Verkouteren,* at 260-61.

In *Migdal v. Rowe Price-Fleming,* No. AMD-98-2162, 1999 WL 104795, slip. op. (D. Md. Jan. 20, 1999), the court held that plaintiff's complaint--again, drafted by plaintiff's counsel here and nearly identical to the complaint here--failed to state a claim under Section 36(b). Similarly, in *Strougo v.*

*BEA Associates,* No. 98 Civ. 3725, 1999 WL 147737 (S.D.N.Y. March 18, 1999), Judge Sweet dismissed another complaint filed by plaintiff's counsel here for failure to state a claim pursuant to Rule 12(b)(6).

Yet another opinion, in *Olesh v. Dreyfus Corp.,* 1995 WL 500491 (E.D.N.Y. Aug. 8, 1995), dismissed a complaint at the pleading stage which alleged that service on multiple boards for substantial compensation rendered directors "controlled" under Section 2(a)(9) of the ICA. The plaintiffs alleged that the directors of the Dreyfus funds were "interested" under the ICA solely because (i) they sat on boards of over fifteen Dreyfus funds and (ii) received over $50,000 annually in compensation for their services. *Id.* at *11. The court held that these allegations failed to plead facts sufficient to demonstrate that directors were "controlled" under § 2(a)(19) and § 2(a)(9)[1]. *Id.* at *16. The court ruled that the plaintiffs were required to present evidence establishing "actual domination and operation." *Id.* Mere influence would fall short of this level of proof.

The ICA's legislative history confirms that Congress did not intend for multiple board membership, standing alone, to compromise a director's independence. H.R. Rep. No. 91-1382 (Aug. 7, 1970) at 15; S. Rep. No. 910184 (May 21, 1969) *reprinted in* 1970 U.S.C.C.A.N. 4897, 4929. In view of the legislative history, the statutory presumption and the prohibition against pleading legal conclusions, plaintiff's general allegations that the Fund's outside directors are

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[1] Plaintiff attempts to distinguish *Olesh* by claiming it has little relevance. However, for purposes of this motion, the court's control analysis of Section 2(a)(9) is directly on point.

"controlled" by Prudential are inadequate. *See Olesh,* 1995 WL 500491, at *16.[2]

II.

*Plaintiff fails to plead facts demonstrating that the fund paid excessive fees in violation of Section 36(b).*

Plaintiff contends that he need not allege that the Fund paid Prudential "excessive" fees to state a claim under 36(b), 15 U.S.C. § 80a-35(b), citing *Green, et al. v. Fund Asset Management, L.P., et al.,* 19 F. Supp. 2d 227, 234-35 (D.N.J. 1998). Defendants maintain that plaintiff must allege that the compensation which has actually been paid to them was excessive or disproportionate. They note that the Second Circuit Court of Appeals has held that a plaintiff must establish that an advisory fee is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining" in order to prevail under Section 36(b). *Gartenberg, supra,* 694 F.2d at 928; *see Krinsk v. Fund Asset Management, Inc.,* 875 F.2d 404 (2d Cir. 1989).

Plaintiff argues that Section 36(b) has not been "amended" by the Second Circuit in *Gartenberg* by limiting it to actions alleging excessive fees and that, even if Section 36(b) can be deemed so limited, the Amended Complaint adequately alleges

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[2] Defendants request this Court to hold as a matter of law that [a claim contesting the independence of] Fund directors who serve on multiple boards for which they receive substantial compensation fails to state a claim under Rule 12(b)(6). I decline to do so.

excessive fees. Plaintiff cites *Green,* in which Judge Debevoise stated:

> Section 36(b) of the ICA is not expressly limited to situations in which the advisory fees received by an investment adviser were excessive disproportionate or otherwise unreasonable. The statute encompasses the receipt of fees by an investment adviser in violation of the adviser's fiduciary duty, as it provides that '[n]o action shall be brought or maintained against any person other than the recipient of such compensation or payments.' 15 U.S.C.A. § 80a-35(3). [19 F. Supp. 2d at 234-35].

Judge Debevoise explained that when fees are collected in breach of fiduciary duty in violation of Section 36(b), "[i]t would flow that such fees were excessive and recoverable to the extent permitted under that Section." *Id.* at 235.[3] *See also Green v. Nuveen Advisory Corp.,* 186 F.R.D. 486, 490 (N.D. Ill. 1999) ("holding that compensation received while acting in breach of fiduciary duty violates" Section 36(b)).

I agree that receipt of compensation while breaching a fiduciary duty violates Section 36(b), 15 U.S.C. § 80a-35(b). Plaintiff argues that since none of the members of the Fund board are independent, their Agreements could not be properly approved as required by ICA Section 15(c), 15 U.S.C. § 80a-15(c). Hence, receipt of funds from invalid Agreements

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[3] Judge Debevoise clarified this holding by stating, "[o]f course, when fees are excessive or disproportionate to the services rendered, this clearly gives rise to a claim for breach of fiduciary duty under Section 36(b)". 19 F. Supp. 2d at 235 n. 11.

breaches their fiduciary duty of ICA Section 36(b), 15 U.S.C. § 80a-35(b). However, the Amended Complaint does not sufficiently allege that the non-employee directors were "interested." Plaintiff's conclusion that a fiduciary breach necessarily flows from the invalid Agreements must therefore fail.

Plaintiff's second argument, that the Amended Complaint adequately alleges excessive fees, is also without merit. In *Krinsk*, the court noted six factors to be considered when determining whether fees are "excessively" large. *Krinsk, supra*, 875 F.2d at 409. Those are the nature and quality of the service, the extent to which economies of scale are realized, the performance of the fund, the fees charged by other advisers, and the independence and conscientiousness of the trustees. *Id.* (*citing Gartenberg, supra*, 694 F.2d at 929-30). The Amended Complaint only addresses the last factor (the - mooted "independence" factor).

As pleaded, the Amended Complaint fails to allege how the fees were excessive in light of the factors articulated in *Krinsk*. *Krinsk*, 875 F.2d at 409. It simply characterizes all the fees as "excessive," without pleading any facts that, if true, would demonstrate that the fee is "so disproportionately large that it bears no reasonable relationship to the services rendered." *Id.*

III.

*Justiciable Controversy.*

Defendant also alleges that plaintiff lacks standing since he has failed to allege damages in accordance with Article III. Plaintiff argues that he meets the standing requirements of Section 36(b) because he is a stockholder of the Fund and nothing else is required. However, in the context of the ICA,

plaintiff must allege enough facts to show that the violations caused some sort of damages. *Seidel v. Lee,* 954 F. Supp. 810, 818 (D. Del. 1996). Plaintiff's argument that simply owning shares of the Fund confers standing upon himself, fails to grasp the distinction between statutory standing and constitutional standing. Satisfying the Article III "case or controversy" requirement is the irreducible constitutional minimum of standing. *Lujan v. Defenders of Wildlife,* 504 U.S. 555, 560, 112 S. Ct. 2130, 119 L. Ed. 2d 351 (1992).

In the context of this case, a properly pleaded Amended Complaint would allege facts sufficient to establish injury. By definition, a violation of Section 36(b) encompasses excessive payments to the fund's advisers. These payments belong to the plaintiff via the Fund. As such, damages would be implicit in a properly pleaded Amended Complaint. However, plaintiff here has failed to properly plead his Amended Complaint, and, as such, the complaint should be dismissed.

## *CONCLUSION*

For the reasons set forth above, I recommend that plaintiff's Amended Complaint be dismissed.

## STATUTE AND RULE

**Section 36(b), Investment Company Act of 1940, 15 U.S.C. § 80a-35(b):**

> **Compensation or payments as basis of fiduciary duty; civil actions by Commission or security holder; burden of proof; judicial consideration of director or shareholder approval; persons liable; extent of liability; exempted transactions; jurisdiction; finding restriction**
>
> For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

**(1)** It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

**(2)** In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

**(3)** No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of

compensation or payments received from such investment company, or the security holders thereof, by such recipient.

**(4)** This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loads for the acquisition of any security issued by a registered investment company.

**(5)** Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

**(6)** No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

**Fed. R. Civ. P. 8(a), 28 U.S.C. Rule 8(a):**

> **Claims for Relief.** A pleading which sets forth a claim for relief . . . shall contain . . . (2) a short and plain statement of the claim showing that the pleader is entitled to relief . . . .

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UNITED STATES DISTRICT COURT
DISTRICT COURT OF NEW JERSEY

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| SHELDON KRANTZ,<br><br>Plaintiff,<br><br>v.<br><br>PRUDENTIAL INVESTMENTS FUND MANAGEMENT LLC and PRUDENTIAL INVESTMENT MANAGEMENT SERVICES LLC,<br><br>Defendants. | 98 Civ. 3722(KSH)<br><br>**FIRST AMENDED COMPLAINT UNDER SECTION 36(b) OF THE INVESTMENT COMPANY ACT OF 1940** |

Plaintiff alleges the following upon personal knowledge as to himself and his own acts, and as to all other matters upon information and belief, based upon the investigation made by and through his attorneys, which investigation included, inter alia, a review of United States Securities and Exchange Commission ("SEC") filings, press releases, news articles, and other publicly available materials.

## Nature Of The Action

1. Plaintiff, a shareholder of Prudential Jennison Growth Fund (the "Fund"), brings this action pursuant to Section 36(b) of the Investment Company Act of 1940, as amended (the "ICA"), 15 U.S.C. § 80a-35(b), against Prudential Investments Fund Management LLC, the investment adviser to the Fund (the "Adviser"), and Prudential Investment

Management Services LLC, the Fund's principal underwriter (the "Distributor"). The Fund is an investment company within a series of the Prudential Investment Portfolios, Inc., a diversified, open-end, management investment company ("Prudential Investment").

2. By this action, plaintiff seeks to recover the compensation received by the Adviser and the Distributor pursuant to management and distribution agreements (the "Agreements"), which were entered into in violation of Section 15(c) of the ICA, 15 U.S.C. § 80a-15(c), and to void the Agreements.

Background

3. The investment company industry is one of the few businesses in which participants act as if there are no economies of scale. In fact, the participants act as if the reverse is true. Arthur Levitt, Chairman of the SEC, testified before Congress on March 19, 1997 that, notwithstanding the enormous amount of monies that have been cascading into mutual funds, "the fee structure of those funds appears to be going up, not down." Levitt Tells Senate Appropriations Panel Concern About Mutual Fund Fee Structure, 29 Sec. Reg & L. Rep. (BNA), 370 (Mar. 21, 1997).

4. After noting, in October, 1996, that "total assets under management now stand at more than $3 trillion [total assets under management have since increased to about $5 trillion], compared with about $450 billion at the beginning of the decade and just $49 billion in 1980," and charting the increase in management fees over the past decades, one commentator stated as follows:

> Given the industry's explosive growth, it's hard to explain why management fees have

> also gone up on a percentage basis. The money-management business is a textbook case of an industry with tremendous operating leverage. It's not capital-intensive, and once assets hit a certain size, each additional dollar that comes in the door can be managed at little additional cost. If anything, management fees should be going down.

Amy Arnott, "The Rising Tide" (Morningstar Inc. 1996). Morningstar, Inc. ("Morningstar") is a leading publisher of analytical information relating to the investment company industry.

5. ICA Section 10(a), 15 U.S.C. § 80a-10(a), mandates that at least 40% of the members of the governing board of every registered investment company not be "interested persons," i.e., they must be independent of the investment adviser. Moreover, ICA Section 15(c), 15 U.S.C. § 80a-15(c), mandates that every agreement with an investment adviser or distributor be approved by a majority of the independent directors. The United States Supreme Court, in Burks v. Lasker, 441 U.S. 471 (1979), after describing the inherent conflict of interest between an investment adviser and an investment company, noted that "the cornerstone of the ICA's efforts to control conflicts of interest . . . is the requirement that at least 40% of a fund's board be composed of independent outside directors." 441 U.S. at 482. (Footnote omitted.) In other words, the independent directors are to serve as "watchdogs" for shareholders as "the structure and purpose of the ICA indicate that Congress entrusted to the independent directors . . . the primary responsibility for looking after the interests of the fund's shareholders." Id. at 484-85. (Footnote omitted.)

6. Notwithstanding the structural protections built into the ICA, investment advisers and their affiliates have been able to engage in widespread fee-gouging.

7. The principal reason for the subversion of the ICA is that the independent directors have largely been co-opted by the adviser, are no longer independent "watchdogs," and have ceased to be able to distinguish the interests of the adviser and its affiliates from the interests of the shareholders.

8. Jack Bogle, founder of the Vanguard Group, one of the largest mutual fund complexes in the world, responded during an interview conducted by Morningstar to the indicated question as follows:

> Q. We've talked about how the industry could do a better job. How about the fund directors?
>
> A. Well, fund directors are, or at least to a very major extent, sort of a bad joke. They've watched industry fees go up year after year, they've watched expense ratios go up year after year, they've added 12b-1 fees. I think they've forgotten, maybe they've never even been told, that the law, the Investment Company Act, says they're required to put the interest of the fund shareholders ahead of the interest of the fund advisor. It's simply impossible for me to see how they could have ever measured up to that mandate, or are measuring up to it.

"Morningstar interviews . . . Jack Bogle, Founder of the Vanguard Group," by Kathryn Haines and Russ Kinnel, www.morningstar.net, posted June 5, 1998.

9. More recently, in the October 1998 issue of Mutual Funds, published by Time, Inc., Mr. Bogle again noted that "Mutual fund fees are exorbitantly excessive." J. Bogle, "Fund Fees Are Beyond Excessive," Mutual Funds at p. 80 (Time, Inc., October 1998). Mr. Bogle went on to explain the reason why mutual fund fees are "exorbitantly excessive," stating:

> Simply put, the substantial economies of scale in this business are not being passed along to shareholders in the form of lower expenses. To the contrary, many fund management firms are earning extraordinary -- and, I would argue, excessive -- profits on a growing pot of assets.
>
> I find it almost unconscionable that an "independent" fund director, who is bound by law and fiduciary duty to represent shareholders, would continue to approve almost whatever fee is proposed to the fund board by the fund manager. Fund boards should be considering fee rate reductions.

Id.

10. A root cause of the transformation of the position of director from "watchdog" to that of a sinecure, is the practice of offering these individuals multiple directorships, i.e., directorships of more than one fund managed by the same investment adviser. The "Fund Director's Guidebook," compiled by eminent practitioners representing the investment advisory industry, cautions that

> the increased responsibility and workload as well as potential conflicts that accompany service on a number of boards must be

> considered when an individual serves on the board of more than one fund with the same or related sponsors.

Task Force - A.B.A. Sec. Bus. L., Fund Director's Guidebook, 52 The Bus. Law. 229, 240 (1996).

11. The National Association of Corporate Directors is a non-profit organization, the membership of which includes more than 1,700 executive officers who serve on, or deal with, corporate boards. It has issued the following guidelines when considering candidates for board membership:

> [T]he Commission recommends that boards in general consider the following guidelines for different categories of candidates:
>
> [a] CEOs and other senior executives of public corporations: Boards should prefer individuals who hold no more than one or two public-company directorships (including the position to be offered) in addition to membership on their own company board.
>
> [b] Other individuals with full-time positions: Boards should prefer individuals who hold no more than three or four public-company directorships (including the position to be offered) in addition to membership on their own organization's board.
>
> [c] Other individuals: Boards should prefer individuals who hold no more than five or six public-company directorships (including the position to be offered).

National Ass'n of Corp. Directors, Report of the NACD Blue Ribbon Commission on Director Professionalism, at 12 (1996). (Footnote omitted.)

12. The relationship between fee-gouging and multiple directorships was documented in a study of trustee compensation for 82 of the largest fund families. "[T]he study revealed a disturbing pattern: The more money trustees get, the more shareholders pay in expenses. This unexpected link between trustees' salaries and fund-family expenses raises serious questions about the role independent trustees play in protecting shareholders." Michael Mulvihill, "A Question of Trust" (Morningstar, Inc. 1996). (Emphasis added.)

13. The allegations in this complaint are remarkably simple, and illustrate these problems. Plaintiff alleges that none - much less 40% - of the members of the Fund's board are independent, as required by ICA Section 10(a). As a result, the Agreements were not negotiated at arm's-length and could not be properly approved as required by ICA Section 15(c). Consequently, the Fund has paid defendants' excessive fees pursuant to invalid, sweetheart contracts, thereby entitling plaintiff to seek recovery of those fees pursuant to ICA Section 36(b).

## Jurisdiction And Venue

14. This action is brought pursuant to ICA Section 36(b), 15 U.S.C. § 80a-35(b). Subject matter jurisdiction exists under 15 U.S.C. § 80a-43, 15 U.S.C. § 80a-35(b)(5), and 28 U.S.C. § 1331.

15. Venue is properly laid in this District because many of the acts and transactions, and much of the conduct, constituting the alleged violations of law occurred herein. The defendants maintain their offices in this District.

16. In connection with the acts, conduct, and other wrongs alleged herein, defendants, directly and indirectly, used the means and instrumentalities of interstate commerce, including the mails and telephone communications.

Parties

17. Plaintiff is, and continues to be, a shareholder of the Fund, an investment company registered under the ICA.

18. The Adviser serves as investment adviser to the Fund and is excessively compensated therefor. Its principle offices are located at 100 Mulberry Street, Newark, New Jersey 07102-4077.

19. The Distributor provides distribution, marketing, administrative, and other services and activities to the Fund. It is a Delaware limited liability company, and an affiliate of the Adviser. The Distributor is excessively compensated for its distribution, marketing, and administrative services.

Claim For Relief

20. The Fund is an "investment company" within the meaning of the ICA. The ICA requires that an investment company such as the Fund be overseen by a board of directors or trustees of whom at least 40% may not be "interested" persons. 15 U.S.C. § 80a-10(a). Such directors or trustees are generally referred to as "independent" directors or trustees.

21. The ICA imposes strict criteria for independence. For example, an independent director or trustee may not have any affiliation or material relationship with a fund's adviser, its underwriter, or a broker/dealer, or with any

of their affiliates. ICA Section 2(a)(19), 15 U.S.C. § 80a-2(a)(19). Under the ICA, an affiliation with a person arises from, among other things, a relationship of control. ICA Section 2(a)(3), 15 U.S.C. § 80a(2)(a)(3).

22. Most investment companies, as here, are externally managed -- they have no officers or employees apart from those supplied by the investment adviser or other service providers. For this reason, independent directors play an especially vital role in the management of funds. Under the ICA, they are required to, among other things: (a) approve any contracts between a fund and its sponsors, underwriters, or advisers; and (b) evaluate and approve fees paid to sponsors and their affiliates, including advisory and distribution fees.

23. The defendants have received substantial fees pursuant to the Agreements. However, as set forth below, the Agreements were not approved by a board of which any (and certainly not 40%) of the members were independent of the Adviser.

24. The Fund has an eleven member board of directors. Three of the eleven directors are acknowledged affiliates of the Adviser.

25. Richard A. Redeker is the President of Prudential Investment, as well as a director of the Fund.

26. Robert F. Gunia is Executive Vice President and Treasurer of the Adviser, as well as a director of the Fund.

27. Mendel A. Melzer is Chief Investment Officer of 38 Prudential Investment mutual funds and annuities, as well as a director of the Fund.

28. The remaining eight directors are not employed by the Adviser, but serve on multiple boards of the funds managed by the Adviser or its affiliates (the "Fund Complex") and receive substantial compensation therefrom:

| Name Of Director | Total 1997 Compensation Received From The Fund And The Fund Complex | Number of Funds |
|---|---|---|
| Edward Beach | $135,000 | 38 |
| Delayne D. Gold | $135,000 | 38 |
| Douglas H. McCorkindale | $ 70,000 | 20 |
| Thomas T. Mooney | $115,000 | 31 |
| Stephen P. Munn | $ 45,000 | 15 |
| Robin B. Smith | $ 90,000 | 27 |
| Louis A. Weil, III | $ 90,000 | 26 |
| Clay T. Whitehead | $ 45,000 | 15 |

29. The excessive number of boards upon which the Fund's directors serve and concomitant assembly-line, truncated board meetings, effectively prevents them from being able to fulfill their statutory role as watchdogs for the public investors. Rather, the Fund's board is effectively controlled by the Adviser and its affiliates and merely rubber-stamps proposals of defendants. As a result, each of the directors is an "interested person" within the meaning of ICA Sections 2(a)(3), 2(a)(19)(A)(i), and 2(a)(19)(B)(i), 15 U.S.C. §§ 80a-2(a)(3), 80a-2(a)(19)(A)(i), and 80a-2(a)(19)(B)(i).

30. Beach, Gold, Mooney, and Weil also serve on the board of directors of The High Yield Fund, Inc. along with Redeker, Gunia, and Melzer.

31. The total compensation shown includes amounts deferred under the funds' deferred compensation plans. Including accrued interest, total deferred compensation amounted to $71,640, $143,909, and $139,097 for

McCorkindale, Mooney, and Smith, respectively.

32. The foregoing compensation is greater than the collective investment these individuals have in each of the funds within the Fund Complex.

33. As alleged herein, ICA Section 10(a), 15 U.S.C. § 80a-10(a), requires that at least 40% of the members of the board of directors of every registered investment company not be "interested persons," i.e., be independent of the investment adviser. ICA Section 15(c), 15 U.S.C. § 80a-15(c), provides, in pertinent part, that it is "unlawful for any registered investment company having a board of directors to enter into" a contract or agreement with an investment adviser or distributor, "unless the terms of such contract or agreement . . . have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party . . .." As more than 60% of the directors of the Fund are "interested persons" within the meaning of the ICA, the Agreements could not have been approved as required by Section 15(c) of the ICA. Accordingly, the Agreements are invalid and the excessive compensation paid to the Adviser and the Distributor wrongly received.

34. By reason of the foregoing, the Adviser and the Distributor have breached their fiduciary duty to the Fund by accepting compensation pursuant to the non-arm's-length Agreements. Plaintiff seeks, pursuant to Section 36(b)(3) of the ICA, the "actual damages resulting from the breach of fiduciary duty" by the Adviser and the Distributor, up to and including, "the amount of compensation or payments received from" the Fund.

**WHEREFORE**, plaintiff demands judgment pursuant to Section 36(b) as follows:

A. declaring that the Adviser and the Distributor violated Sections 10(a), 15(c), and 36(b) of the ICA, and that the Agreements are void ab initio;

B. awarding damages against the Adviser and the Distributor, consisting of all fees paid to each of them by the Funds beginning one year before this action was instituted, together with interest, costs, disbursements, attorneys' fees, and such other items as may be allowed to the maximum extent permitted by law; and

C. such other and further relief as may be just and proper.

Dated: December 10, 1998

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